No. 16702

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

Schalk Chemical Company, a corporation, Gerald I. Farman, Hazel I. Farman, John Carver Baker and Patricia Baker,

Petitioners,

vs.

Commissioner of Internal Revenue,

Respondent.

On Petition for Review of Decisions of the Tax Court of the United States.

PETITIONERS' REPLY BRIEF.

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Introduction.

Respondent's brief reiterates the Tax Court's reasoning and in like vein submits arguments predicated directly or obliquely on one primary proposition, that determination of this case is governed by the form, not the substance, of the transactions which allegedly give rise to the assessments in question.

Respondent (like the Tax Court) does not come to grips with this case.

I.

Viewed in the Light of Applicable Law Relating to Spendthrift Trusts, the Terms of the Settlement Agreement Demonstrate That the $25,000 Was Paid for Smith's Surrender of Control of the Company.

Neither the Tax Court nor respondent discusses or attaches any significance to the fact that the trust, which until December 29, 1950, owned all the shares of the Company, was a spendthrift trust.[1]

The spendthrift provisions of the trust [Ex. 1, Art. II, Paragraph (O), pp. 14-15] are quoted at pages 26 to 27 of petitioners' opening brief. Any alienation of the beneficial interests was prohibited.

As discussed at pages 27 to 29 of petitioners' opening brief, the trust was created in California which recognizes and enforces spendthrift trusts.

Under California law, the 1948 settlement agreement [Ex. 16] wherein Smith purported to contract to sell his beneficial interest to the other beneficiaries was abortive as such. An assignment of or contract to assign a beneficial interest in a spendthrift trust passes no interest of any kind in or to the trust property and is not specifically enforceable even after termination of the trust.

As stated in *Kelly v. Kelly*, 11 Cal. 2d 356, 79 P. 2d 1059, 119 A. L. R. 71 (1938):

> ". . . A voluntary assignment executed before payment to the beneficiary [of a spendthrift trust]

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[1]The Tax Court mentions the fact once [R. 44], respondent twice (Br. pp. 7, 20).

> confers on the assignee *no right to demand payment or delivery from the trustee as it becomes due to the beneficiary* . . .
>
> * * * * * * * * * * * *
>
> ". . . [A]n assignment by the beneficiary, in the nature of a promise to pay or turn over trust property when received by him, . . . gives the promisee *no right in specific trust property received by the beneficiary, or in its proceeds,* . . ." (11 Cal. 2d at pp. 362-363.)[2]

And, in Scott on *Trusts* (2d ed.), Vol. II, §152.6, at page 1067:

> "Where the interest of a beneficiary of a trust is by the terms of the trust or by statute not transferable by him, and he makes a contract to assign it, *the contract is not specifically enforceable* even though consideration was received by the beneficiary."

Also see California Civil Code, Section 3386.

Such an assignment or contract to assign is wholly invalid under California law, except as it may give the promisee the dubious right to sue to recover damages personally from the beneficiary if he fails to perform. (*Kelly v. Kelly, supra.*) But suppose Smith had died prior to termination of the trust. The agreement, being invalid, was not binding on his heirs. No one would have been answerable even for damages.

It must be assumed that the settlement agreement with Smith was written with full awareness of its legal

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[2]Emphasis in quoted material added throughout unless otherwise noted.

ineffectiveness as a contract for the purchase and sale of Smith's beneficial interest. (The other beneficiaries, it should be noted, were represented by well known and very able counsel, Stanley W. Guthrie.) Certainly the other beneficiaries did not borrow the $25,000 and pay it to Smith for nothing. What then was the purpose of the agreement?

Petitioners contend that the purpose of the settlement agreement was to secure Smith's resignation as Supervisor of the trust and consequent relinquishment of control of the Company and that it was for this that the $25,000 was agreed to be (and was) paid. Incidentally as far as the other beneficiaries were concerned, but of importance to Smith from a tax standpoint, the other beneficiaries were given the right, if they desired, to purchase Smith's share of the trust property for $20,000, provided he survived termination of the trust and chose to honor the agreement [*cf.* Ex. 22].

The terms of the settlement agreement confirm this. The first paragraph states that, in consideration of $25,000 "in hand" paid to Smith by the other beneficiaries and for which receipt was acknowledged, Smith agreed to sell to the other beneficiaries and the other beneficiaries agreed to buy his beneficial interest in the trust upon its termination and distribution [Ex. 16, p. 1; R. 47]. The second through the seventh paragraphs provide that within 30 days after termination and actual distribution of the trust the other beneficiaries would pay $20,000 to Smith [Ex. 16, p. 2;

R. 47-48] by deposit in escrow [Ex. 16, p. 3; R. 49] pursuant to escrow instructions providing that if the other beneficiaries failed to deposit "the aforesaid purchase price" Smith could terminate the escrow [Ex. 16, p. 4; R. 50].

Smith agreed to resign immediately as Supervisor of the trust and as an officer and director of the Company and to secure the resignation of the officers and directors he had appointed and the parties agreed to enter into concurrently a stipulation for entry of judgment in the 1947 Superior Court action to remove Smith as Supervisor [Ex. 16, pp. 4-5; R. 50-51].

It is not until the fifth page of the agreement that the sum of $45,000 is stated to be the purchase price of Smith's beneficial interest [Ex. 16, p. 5; R. 51]. The particular provision was put into the agreement at the insistence of Smith's attorney [R. 447-448].

Taken as a whole, what does the 1948 agreement add up to? Eliminating all of the nugatory provisions purporting to commit Smith to sell and the other beneficiaries to buy his beneficial interest on termination of the trust, the objective of the agreement becomes clear. Its purpose was to secure the immediate resignation of Smith as Supervisor of the trust and as President and director of the Company and the resignation of the officers and directors appointed and controlled by him. Smith's relinquishment of control took place immediately upon execution of the agreement [R. 34-35]. It was to accomplish this, and only this, that the $25,000 was paid.

II.

The $25,000 Was Paid for the Protection and Preservation of the Company.

At pages 4 to 5 and 13 to 16 of their opening brief, petitioners outlined the testimony and evidence supporting their contention that on January 15, 1948, the date of the 1948 settlement agreement, and prior thereto, reasonable grounds existed for the belief that Smith's management and policies were endangering the Company and that the Company might suffer irreparable damage and possible failure prior to termination of the trust on December 29, 1950. (Smith's extraordinary trust powers and right to control the Company, of course, would have ended automatically when the trust terminated. He was only a one-sixth beneficial owner.) Petitioners also pointed out that the testimony and evidence so outlined were not contradicted by Smith in any essential respect (Br. p. 16). Respondent does not dispute this.

Assuming *arguendo* that the Company paid the $25,000 to Smith in consideration of his giving up control and management of the Company, respondent asserts (Br. p. 36) that the Company has failed to meet its burden of proving that the expenditure was an ordinary and necessary business expense and in support thereof is content to rely entirely on this statement from the Tax Court's opinion:

> ". . . we are not convinced that the management of the corporation under Smith was incompetent and that their action was either necessary or desirable to preserve its business" [R. 59].

This asserted finding, however, misses the mark completely. It was not the Company's burden to prove *to*

the Tax Court's satisfaction that Smith's management was "incompetent" or that his removal was necessary to preserve the Company's business. This would place an impossible burden on the Company. As shown at pages 17 to 18 of petitioners' opening brief, the question which the Tax Court should have passed on, but did not,[3] is whether at the time of the settlement there existed reasonable grounds for the belief that Smith's management and policies were jeopardizing the future of the Company. If such belief was well grounded—*as it was*—an expenditure made to cause Smith to relinquish control qualifies as an ordinary and necessary business expense for the protection and preservation of the Company. See the cases cited by petitioners at pages 11 to 13 and 17 to 18 of their opening brief, and particularly *Levitt & Sons v. Nunan,* 142 F. 2d 795 (2 Cir. 1944), and *Boulevard Frocks, Inc.,* T. C. Memo. Dec. (1943). In *Boulevard Frocks,* for example, amounts paid by a company to buy up the employment contracts of certain of its stockholders who were disrupting its business were held to be ordinary and necessary business expenses, to preserve, promote and protect the company's business.

Respondent chooses not to discuss any of the cases cited by petitioners in this regard, presumably because of reliance on the *form* of the transaction between Smith and the other beneficiaries. And, it was on the basis of *form* that the Tax Court dismissed the cases cited at pages 18 to 19 of petitioners' opening brief concerning the Company's obligation to reimburse

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[3]Compare, "We are satisfied that they thought their participation would be beneficial to the corporation." [R. 59.]

the other beneficiaries for the $25,000 paid to Smith, to preserve and protect the Company.

An additional case should be noted, *Waring Products Corporation*, 27 T. C. 921 (1957), in which it was stated:

> "We know of no requirement that there must be an *underlying legal obligation* to make an expenditure before it can qualify as an 'ordinary and necessary' business expense . . ." (27 T. C. at p. 929.)

The entire scope of the Tax Court's decision and respondent's position on deductibility of the $25,000 is epitomized in these statements from the opinion below:

> "This reasoning overlooks the fact that *the trust agreement,* which created their beneficial interests, *placed complete control of Schalk in Smith,* the supervisor of the trust, *and prevented them from acting for or on its behalf. Not having any power to act for Schalk,* we fail to see how any action taken by them can be deemed to be the action of Schalk." [R. 58.]

But this approach dramatically places form over substance. It overlooks the conflict of interest between Smith, as supervisor of the trust, and Smith, as an individual beneficial owner. For reasons that had nothing to do with the welfare of the Company [R. 434; quoted by respondent, Br., p. 25], Smith refused to let the Company be a party to or authorize the settlement, although he was cognizant that something had to be done for the Company's protection [Ex. 22].

As stated in *Fox v. Harrison,* 145 F. 2d 521 (7 Cir. 1944), at p. 522:

> ". . . [The Government's] theory is apparently predicated upon the mere form of the transaction, without giving consideration to the substance. In reality, the involved stock was purchased by the corporation . . ."

The *Fox* case is discussed in full at pages 31 to 32 of petitioners' opening brief. The "involved stock" was purchased by Fox, a minority shareholder. The corporation had been unable to buy the stock. It did not authorize Fox to buy the stock. Fox bought it, however, for the Company's protection. The Court treated the transaction as in reality a purchase of the stock by the corporation.

Likewise here, the Company was not able to act for its own protection. The majority owners acted for it. The $25,000 payment to Smith, in reality, was a payment made directly by the Company and deductible by it.[4]

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[4]Respondent suggests that in any event the expenditures were not deductible in 1950 because the payments were made in 1951 (Br. pp. 19, 36). If disallowance were on that ground, the determination should so declare so that the Company can claim relief under Section 1311 of the Internal Revenue Code of 1954. None of the years involved, commencing with 1948, is barred from adjustment under Section 1311. The Company, however, is on an accrual basis and for that reason accrued the $25,000 liability in 1950, the year in which it promised to make the payment [Ex. 23].

III.

Neither the Reimbursement of the $25,000 nor the Payment of the $20,000 Constituted a Taxable Dividend to the Other Shareholders.

As discussed in Point I the other beneficiaries acquired no capital asset or right to a capital asset by reason of the $25,000 payment to Smith. The payment, however, did serve to rid the Company of Smith's domination. As discussed in Point II it was paid for that purpose, to protect the Company.

The other beneficiaries had to borrow the $25,000 which was paid to Smith [R. 186; Exs. 19, 20, 21, 36]. They realized no economic gain from the Company's reimbursement of the $25,000. And, they derived no more benefits from the change in management than they would have derived had the Company paid the $25,000 directly to Smith, in which event the individual petitioners could not have been charged with any omitted dividend income [*cf.* R. 58-59].

As observed by this Court in *Niederkrome v. Commissioner of Internal Revenue,* 266 F. 2d 238 (9 Cir. 1959), at p. 243:

> "It can be argued that taxpayers got full control of the corporation. But should this circumstance, standing alone, be considered an economic or financial advantage?"

The other beneficiaries paid Smith for the protection of the Company. As discussed in Point II, the transaction should be treated in substance as a pay-

ment of the $25,000 by the Company directly to Smith. Since the money was borrowed and paid by the other beneficiaries *for the Company* its reimbursement is not a dividend. This proposition is supported by *Fox v. Harrison,* 145 F. 2d 521 (7 Cir. 1944), discussed and quoted at pages 31 to 32 of petitioners' opening brief. Respondent does not discuss the *Fox* case.

Moreover, for the reasons stated in Point I, the settlement agreement between Smith and the other beneficiaries was ineffective as a contract for the purchase and sale of Smith's beneficial interest because of the spendthrift provisions of the trust. The other beneficiaries *were not obligated* to pay $20,000 to Smith in 1951. The agreement could not have been enforced against them. The Company's payment of $20,000 to Smith in 1951 for the shares of the Company's stock distributed to him, therefore, did not satisfy any obligation of the other shareholders and did not result in a distribution essentially equivalent to a dividend to the other shareholders. This proposition is supported by *Holsey v. Commissioner of Internal Revenue,* 258 F. 2d 865 (3 Cir. 1958), and Rev. Rul. 58-614, 1958-2CB 920, discussed and quoted at pages 33 to 34 of petitioners' opening brief.

In all events, assuming (without conceding in any respect) that the settlement agreement, as contended by respondent, was a valid and enforceable contract for the purchase of Smith's stock interest on termination of the trust (despite the spendthrift provisions of the trust) and that the $25,000 represented truly a down payment on the purchase price (which, as discussed above, is not the case), petitioners submit that *John A. Decker,* 32 T. C. 331 (1959), discussed and quoted

at pages 34 to 37 of petitioners' opening brief, is indistinguishable from this case and requires reversal of this case insofar as the individual petitioners are concerned. Respondent does not discuss the *Decker* case, and it is not cited in the opinion below.

The taxpayer-stockholders in *Decker* were obligated by written agreement to purchase the stock of a deceased stockholder. They purchased the stock and immediately transferred it to the corporation for the same price. The Tax Court held that there was no true economic benefit to the survivors justifying treating the redemption as a constructive dividend to them, stating:

> "*Petitioners did not receive any true economic benefit from the transactions when considered as a whole.* They had the same amount of cash and the same number of shares of stock after the transactions were completed as they had before the death of the deceased stockholder. Their stock represented a higher percentage of equity in the basic assets of the company, but those assets were reduced proportionately so the stock actually represented the same value, assuming that the book value for which the stock was bought and sold represented the value of the underlying assets. So petitioners gained nothing from the distribution unless it is that the use of company funds to meet their obligations under the stock purchase agreement produced an economic benefit for them.
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> * * * * * * * *
>
> ". . . *The corporation did not pay a pre-existing debt of the petitioners, the satisfaction of which would increase their net worths. They realized no economic benefit from the transaction.*"

The net worths of the other shareholders in this case were not increased; in fact they were decreased. Smith's stock interest was not worth $45,000.[5] (On the question of whether payment of an excessive price results in a dividend to the remaining stockholders, see *Fred F. Fischer,* T. C. Memo. Dec. (1947), discussed and quoted at pages 37 to 38 of petitioners' opening brief.) The other shareholders had the same number of shares after the transactions were completed as they had before. The fact that the purchase price, under respondent's theory, was payable $25,000 "down" and $20,000 on termination of the trust is a distinction without a difference.

Rev. Rul. 59-286, 1959-36 IRB 9, discussed and quoted at pages 36 to 37 of petitioners' opening brief, also is inherently inconsistent with the Tax Court's decision in this case. Rev. Rul. 59-286 holds that where a surviving stockholder had entered into an agreement that, upon the death of the other stockholder, he would either purchase the decedent's stock or vote his stock for dissolution of the corporation, and instead the corporation redeemed the stock, no dividend results to the surviving stockholder. The Ruling contains this significant statement:

> ". . . *there is no authority affirmatively supporting* the proposition that a redemption of one stockholder's shares, at fair market value, constitutes a dividend to a remaining shareholder . . ." (1959-36 IRB at p. 10.)

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[5]The book value of the Company's stock on December 31, 1947, was $1.33 per share [R. 35].

Conclusion.

The decision in the Company's case should be reversed and the case remanded. The decisions in the individual petitioners' cases should be reversed.

September 30, 1960.

Respectfully submitted,

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